Amend Government Code Section 7510 to replace a valuation methodology related to possessory interests in state retirement system-owned property which was ruled unconstitutional. (Housekeeping)

Source: Property and Special Taxes Department

Existing Law. In certain instances, a property tax assessment may be levied when a person or entity uses publicly-owned real property that, with respect to its public owner, is either immune or exempt from property taxation.[1] These uses are commonly referred to as “possessory interests” and are typically found where an individual or entity leases, rents, or uses federal, state or local government facilities and/or land.

Government Code Section 7510 contains provisions specific to possessory interests in state retirement system-owned property (i.e., property owned by the Public Employees Retirement System (PERS) and the State Teachers Retirement System (STRS)). Section 7510(b)(1) specifies a valuation methodology to value a lessee’s possessory interest in PERS- and STRS-owned property. As discussed below, the court of appeal ruled the method unconstitutional because in some cases it taxes the lessee based on the entire fee simple interest[2]. This method is improper because the lessee is assessed for both the possessory and reversionary interest even though the lessee only owns a possessory leasehold interest.

Specifically, Section 7510(b)(1) provides that for property leased *entirely* by the lessee, the assessed value is limited to the full cash value of the taxable possessory interest. If, however, the lessee has leased less than the entire property, the assessed value of each taxable possessory interest is the greater of (1) the full cash value of the taxable possessory interest or (2) a value based on the possessor's allocable share of the full cash value of the real property, which is the value that would have been enrolled under Article XIII A of the California Constitution and related statutes for the entire fee simple interest. Subdivision (b)(1) further provides that each possessor's "allocable share" shall be a simple allocation based on the square feet leased by the possessor divided by the total leasable square feet of the real property.[3]

On May 7, 2013, the Second District Court of Appeal (*California State Teachers' Retirement System v. County of Los Angeles,* (2013) 216 Cal.App.4th 41[4] held that the valuation methodology provided in Section 7510(b)(1) is unconstitutional. First, the court noted that Section 7510(b)(1) does not become constitutional simply because it shifts the tax on the reversionary interest to the lessees. The court concluded that the value of rights retained by the exempt owner of the real property (reversionary interest) must be excluded in order to determine the proper value of the lessee's taxable possessory interest. Second, by including the full value of the fee interest in the assessable value of the lessee's possessory interest, Section 7510(b)(1) also violates the prohibition on taxing property in excess of its fair market value. Including the value of the retirement system's reversionary interest in the value of the lessee's possessory interest increased

[1] Revenue and Taxation Code Section 110.
[2] The entire fee simple interest includes the possessory interest plus the reversionary interest.
[3] Assessors' Handbook Section 510, *Assessment of Taxable Possessory Interests*, page 73.
[4] Letter to Assessors 2014/32.

the assessed value of the possessory interest above its fair market value. The court opined that the correct possessory interest valuation standard is fair market value, rather than the formula dictated by Section 7510(b)(1).

The court directed that the matter be remanded back to the assessment appeals board to determine the proper value of the possessory interest pursuant to the valuation method contained in the Board of Equalization's regulation Property Tax Rule 21, "Taxable Possessory Interests – Valuation." Thus, Property Tax Rule 21, which is applicable to possessory interests generally, is the proper valuation standard for investment property owned by state public retirement systems.

This Proposal. This proposal amends Government Code Section 7510 to conform to the court ruling. Specifically, it deletes the formula held to be unconstitutional and replaces it with a reference to the pre-existing regulation the BOE has adopted that applies to the valuation of taxable possessory interests. This change will ensure that these possessory interests will not be valued in excess of fair market value.

Background. The BOE issued guidance via Letters to Assessors 2014/023 regarding this court decision and previously filed an *amicus curiae* brief with the court.

Section 7510 of the Government Code is amended to read:

7510. (a) (1) Except as provided in subdivision (b), a public retirement system, which has invested assets in real property and improvements thereon for business or residential purposes for the production of income, shall pay annually to the city or county, in whose jurisdiction the real property is located and has been removed from the secured roll, a fee for general governmental services equal to the difference between the amount that would have accrued as real property secured taxes and the amount of possessory interest unsecured taxes paid for that property. The governing bodies of local entities may adopt ordinances and regulations authorizing retirement systems to invest assets in real property subject to the foregoing requirements.

(2) This subdivision shall not apply to any retirement system which is established by a local governmental entity if that entity is presently authorized by statute or ordinance to invest retirement assets in real property.

(3) This subdivision shall not apply to property owned by any state public retirement system.

(b) (1) Whenever a state public retirement system, which has invested assets in real property and improvements thereon for business or residential purposes for the production of income, leases the property, the lease shall provide, pursuant to Section 107.6 of the Revenue and Taxation Code, that the lessee's possessory interest may be subject to property taxation and that the party in whom the possessory interest is vested may be subject to the payment of property taxes levied on that interest. <u>The lease shall be valued in accordance with regulations adopted by the Board of Equalization for the valuation of taxable possessory interests.</u> ~~The lease shall also provide that the full cash value, as defined in Sections 110 and 110.1 of the Revenue and Taxation Code, of the possessory interest upon which property taxes will be based shall equal the greater of (A) the full cash value of the~~

~~possessory interest, or (B), if the lessee has leased less than all of the property, the lessee's allocable share of the full cash value of the property that would have been enrolled if the property had been subject to property tax upon acquisition by the state public retirement system. The full cash value as provided for pursuant to either (A) or (B) of the preceding sentence shall reflect the anticipated term of possession if, on the lien date described in Section 2192 of the Revenue and Taxation Code, that term is expected to terminate prior to the end of the next succeeding fiscal year. The lessee's allocable share shall, subject to the preceding sentence, be the lessee's leasable square feet divided by the total leasable square feet of the property.~~

(2) Except as provided in this subdivision, the property shall be assessed and its taxes computed and collected in the same manner as privately owned property. The lessee's possessory interest shall be placed on the unsecured roll and the tax on the possessory interest shall be subject to the collection procedures for unsecured property taxes.

(3) An investment by a state public retirement system in a legal entity that invests assets in real property and improvements thereon shall not constitute an investment by the state public retirement system of assets in real property and improvements thereon. For purposes of this paragraph, "legal entity" includes, but is not limited to, partnership, joint venture, corporation, trust, or association. When a state public retirement system invests in a legal entity, the state public retirement system shall be deemed to be a person for the purpose of determining a change in ownership under Section 64 of the Revenue and Taxation Code.

(4) Notwithstanding any other provision of law, fees charged pursuant to this section and collected prior to July 1, 1992, shall be deemed valid and not refundable under any circumstance. Notwithstanding any other provision of law, fees, interest and penalties, if any, asserted to be due pursuant to this section that were not charged or collected prior to July 1, 1992, shall be deemed invalid and not collectable under any circumstance.

(5) This subdivision shall apply to the assessment, computation, and collection of taxes for the fiscal year beginning on July 1, 1992, and each fiscal year thereafter. For the 1992–93 and 1993–94 fiscal years, in the case where a lessee's possessory interest existed for less than the full fiscal year for which the tax was levied, the amount of tax shall be prorated in accordance with the number of months for which the lessee's interest existed.